

Financial Horizons

Arizona State Retirement System

Fall 2006

Message from ASRS Director Paul Matson

In the last edition of this newsletter, I discussed the ASRS strategic plan and how we use the document as our road map to help ensure we stay on track to provide the best service and fiscal integrity we can to our members and retirees.

While our strategic plan is an important tool for us, it's not the only way we gauge our performance. One of the many ways we assess our progress toward meeting our goals is to measure member satisfaction. For more than five years, the ASRS has used member surveys and focus groups to understand what is important to members and how we can continue to improve service delivery.

Each month, our agency sends a survey to members who recently completed a service transaction, asking them to rate their satisfaction with the service they received, as well as their overall impression of the ASRS and our website. I want to express my gratitude to those who have taken the time to complete a survey in the past, and I encourage members to continue to provide us with their feedback in the future.

I am pleased to report that member satisfaction is strong and is improving, particularly as our business re-engineering and information technology projects are completed. These information technology projects have allowed us to greatly improve service, while keeping administrative costs stable. For example,



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Looking to the Future

ASRS Studies a Range of Ideas to Keep Plans Healthy for Current and Future Members

The ASRS, as part of its fiduciary responsibilities, regularly undertakes a review of various components of the plans it administers (defined benefit pension plan; system plan; long term disability income plan; health insurance program).

The purpose is to ensure appropriate and prudent planning and strategic thinking is taking place that will improve plan efficiency, minimize costs, promote equity and fairness, mitigate the upward pressure on the contribution rate, and ensure that the plans are viable for current and future members.

At its public meeting on July 21, 2006, the ASRS Board of Trustees received information and an update from Director Paul Matson on a Plan Design Sensitivity Analysis.

Specifically, four possible modifications were discussed that would mitigate future increases in contribution rates and increase fiscal integrity. These possible modifications will be discussed with various constituent groups this fall prior to any potential changes.

Discussed were:

- For future members, changing the salary averaging method used to calculate a member's retirement benefit from the current 36-month to a 60-month calculation. This change would better capture the representative salary contributed by the employee over their working career. Specifically, it would help combat "salary spiking" that uses dramatically inflated salaries in the last years of employment, thereby artificially inflating the lifetime retirement benefit.
- For future members, changing the normal retirement "rule of 80" to a "rule of 85" (years of service plus age to reach the point total for normal retirement). Such a change takes into account increases in life expectancies of new members with potentially more years spent in retirement.
- For future members, removing the "enhanced" refund provision in which an employee with five or more years of service receives a portion of the employer contribution upon termination of membership and withdrawal of account balance. The reasoning is that by not allowing withdrawal of the employer contributions, an incentive is created to retain public service

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ASRS News

Member Statements to be Mailed This Fall

Annual Member Statements are scheduled to be mailed to all active and inactive members from mid-September to mid-October. Watch for your personalized statement in the mail.

Your Member Statement includes your personal data on file, beneficiary information, salary history, account activity, a summary of service purchase, if applicable, and information on maximizing your ASRS pension benefits.

Also included are benefit estimates for your monthly pension when you retire. You'll see what your pension could be if

you retire at the earliest opportunity, or continue working until you reach a normal retirement date. These are estimates only, based upon your current salary and projected years of service.

Your annual statement provides an opportunity for you to verify information on file at the ASRS. It's important for members to check and verify information such as beneficiaries, addresses and contact numbers, and other personal information.

Be sure to watch for your statement; read it carefully and file it with other important personal papers.

ASRS Has New Website Address

www.azasrs.gov

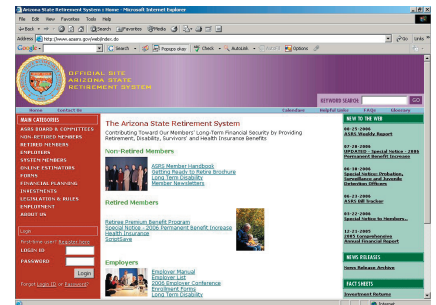
To comply with standard practices for all state agencies, the Arizona State Retirement System has changed its website address.

www.azasrs.gov is now the home of the retirement system's website. The address had been www.asrs.state.az.us. The old address will re-direct users automatically to the new address for the next several months. Beginning in 2007, however, the old address will no longer work.

The ASRS website has a host of topics and information, including the most up-to-date news on benefits, legislation and meetings.

There are sections devoted to members, retirees and employer partners, as well as a selection of publications and documents.

We invite you to bookmark the site and check it periodically to see what's new!



ASRS Supplemental Retirement Savings Plan Nearing Implementation

The ASRS is preparing a new program that will allow active, non-State of Arizona members to save additional tax-deferred money for retirement. The ASRS is seeking an investment and customer service provider for this 401(a) Supplemental Retirement Savings Plan (SRSP) to provide numerous investment options and quality customer service. A similar 401(a) plan will be offered to State of Arizona employees through the Arizona Department of Administration. The ASRS SRSP will be available to all other ASRS member employers, who may elect to participate.

The SRSP, approved by the Legislature in 2001 and amended in 2003, allows eligible members to contribute tax-deferred money every pay period. Members can contribute a maximum yearly amount up to 100 percent of pay or \$44,000, whichever is lower. This limit is higher than limits for the 457 or 403(b) plans offered to many ASRS members.

The SRSP is offered in addition to the Defined Benefit Pension that you will receive upon retirement. It is a common belief

that most individuals need to receive income from three sources during retirement to be financially secure. Those three sources are Social Security, employer-provided retirement plans (such as the ASRS plan), and personal savings, which may include a 401(a), 457 or other plan. Utilizing the SRSP may be a convenient, regular way to augment your personal savings.

In addition to increasing your financial security at retirement, contributing to the SRSP benefits you now by reducing your income tax liability. For example, if you earn \$35,000 per year and you contribute 10% or \$3,500 to the SRSP, your taxable income will be only \$31,500. Your full salary will still be used to determine your highest annual average salary for purposes of calculating your ASRS retirement benefit.

The ASRS expects to begin employer sign-up in early 2007, with employee enrollment beginning concurrently. Please check the ASRS website, www.azasrs.gov, for updates.

Retiree News

ASRS Health Insurance Open Enrollment Begins October 2

The Arizona State Retirement System annual Open Enrollment period, during which retirees may elect to make changes to their medical and/or dental plans, will take place October 2 through November 3, 2006. All changes become effective January 1, 2007.

Open Enrollment applies to any retired member of the Arizona State Retirement System (ASRS), Public Safety Personnel Retirement System (PSPRS), Elected Officials' Retirement Plan (EORP), Corrections Officer Retirement Plan (CORP), University Optional Retirement Plan (UORP), or any member who is receiving a long-term disability (LTD) benefit from the ASRS program, and who is not enrolled in health benefits through his or her former employer. Members or any eligible dependents who have not taken the opportunity to enroll previously in one of the group medical or dental plans also will be able to enroll during this period.

If you are enrolled in the Medicare Advantage HMO plan, Secure-Horizons Direct (soon to become the Senior Supplement Plan), the non-Medicare HMO plan, or the Indemnity plan, your current ASRS medical plan elections will automatically carry forward

to 2007. **All PPO plan members must re-enroll in one of the new PPO plans if continued coverage is desired.** For detailed information please read your Open Enrollment Brochure, which will be mailed in mid-September to your home address on file.

Informational presentations are scheduled throughout Arizona during October to further explain each portion of your retiree health insurance program. The schedule of meetings is included in the Open Enrollment Packet.

If you have not received your packet by October 10, please contact the Member Services Division to request one. All packets are mailed to the address of record on file with the ASRS. If you have made address changes with your former employer but not with the ASRS, your address may not be updated in your ASRS data file. It is your responsibility to let the ASRS know if and when you have had an address change.

Beginning Monday, September 25, a special phone number for open enrollment will be available. In Phoenix, call 602-240-5350, in Tucson, call 520-239-3100 extension 5350, or from outside Phoenix and Tucson call 800-621-3778 extension 5350.

NOTE: If you are making new elections or adding or deleting dependents from your health insurance coverage, your enrollment form must be received by the ASRS or be postmarked no later than midnight on Friday, November 3, 2006.

Questions & Answers on the Permanent Benefit Increase

The ASRS has received a number of inquiries from retired members regarding the Permanent Benefit Increase program. For the past 12 years, retired members have received increases to their monthly pensions under this program. Funds used to pay for the increase have been fully paid out in previous years.

Below is a summary of many of the commonly asked questions related to the PBI program.

Question: What exactly is the Permanent Benefit Increase? Is it the same as a cost of living increase or a raise?

Answer: State statute 38-767 outlines the provisions for providing what is termed a Permanent Benefit Increase to retired members. Funds to pay for the PBI come from excess earnings on the actuarial value of the overall ASRS fund. When excess earnings are identified, a formula that includes years of service is used to determine each individual retired member's PBI, which, if available, is applied at the beginning of each fiscal year, July 1. Once granted, the PBI cannot be taken away; pension checks cannot be reduced, even in years when there are no excess earnings or when there are negative

earnings. The purpose of the PBI is to help retired members keep pace with increasing living expenses, but the PBI is not tied to any cost of living index and is not guaranteed to be paid annually. The PBI should not be seen as a "raise," as the pension check is an annuity, not a paycheck.

Q: How much has the PBI been in the past?

A: The monthly increase varies for each retiree based upon their years of service. An amount is calculated for each year of credited service, and has ranged from \$8 per year of service in 1994 to more than \$35 per year of service in 2003 and 2004. For 2005, the increase was \$25.90 per year of service. Over the past 10 years, retirees have seen an average 45 percent increase to their monthly pension checks due to the PBI and as much as 50 percent with the addition of other ad hoc increases.

Q: Didn't my contributions made while I was working pay for the PBIs that I receive in retirement?

A: No. No member has ever directly paid for the PBI; rather, the PBI has been paid from excess earnings on the ASRS fund.

Q: How do you arrive at the amount available to fund the PBI?

A: The pool of money for the PBI is generated from excess returns on the actuarial value of the overall fund; it is not the same as the market rate of return. To determine if there

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Legislative Update

ASRS and Retirement Legislation from the 2006 Legislature

The 47th Legislature-Second Regular Session adjourned sine die on June 22, 2006. The general effective date for bills passed is September 21, 2006.

Below is a brief summary of bills that have been passed into law that may affect ASRS members. To view legislation in its entirety, visit the Arizona State Legislature website at www.azleg.gov

Senate Bill 1167 – Optional Forms of Retirement (Laws 2006, Chapter 309)

This bill, signed by the Governor on June 1, 2006, amends statutes to limit the ability of future retired members of the ASRS to alternate between retirement benefit options. A member who retires after the effective date may exercise a one-time election to rescind the joint and survivor annuity or period-certain option and select a new annuity option, but only if the originally named annuitant dies or ceases to be a contingent annuitant under the terms of a qualified domestic relations order.

Note: The ASRS is awaiting a private letter ruling from the Internal Revenue Service that is required prior to implementation of this statute.

Senate Bill 1168 – Federal Conforming Changes (Laws 2006, Chapter 157)

This bill, signed by the Governor on April 17, 2006, modifies state statutes to conform to federal law regarding: contributions paid for qualifying active members called to active military service; beneficiaries and payments made when no beneficiary survives the member; survivor benefit calculations and granting the ASRS Board the authority to determine a rate; and minimum required distributions of retirement benefits in accordance with the Internal Revenue Code.

House Bill 2082 – Spousal Notification (Laws 2006, Chapter 103)

This bill, signed by the Governor on April 12, 2006, places in law the following requirements on the part of the ASRS member:

- A member is required to notify their current spouse at any time a beneficiary is designated, if the beneficiary designated is someone other than the current spouse; and,
- A retiree is required to notify their current spouse at any time a change to their beneficiary or annuity option is made, if the current spouse is a beneficiary.

House Bill 2103 – Termination Incentive Program (Laws 2006, Chapter 106)

This bill, signed by the Governor on April 12, 2006, clarifies

statutory language put in place last year by changing the term “retirement” to “termination.” The statute regulates employer incentive programs that lead to employees terminating employment and any monetary incentives that may be provided that may affect contributions due to the ASRS.

House Bill 2113 – Continuation of the ASRS (Laws 2006, Chapter 125)

This bill, signed by the Governor on May 8, 2006, extends the statutory life of the ASRS for 10 years through July 1, 2016.

House Bill 2340 – Repeal of the ASRS Modified DROP Program (Laws 2006, Chapter 12)

This bill, signed by the Governor on March 24, 2006, repeals statutes passed into law in 2001 and modified in 2003 that allowed for the creation of a Deferred Retirement Option Plan to be offered through the ASRS. Implementation of a modified DROP program would have led to increased contribution rates for all members and employers.

Q & A on PBI, continued from page 3

are excess earnings, the fund must have earned more than the actuarial assumed rate of return of 8 percent; however, investment increases and decreases to the fund are “smoothed” over a 10-year rolling period; that is, the positive or negative returns are not applied all in the same year, but instead recognized over a 10-year period. The reason for smoothing, an acceptable industry practice, is to minimize excessive increases or decreases in the contribution rate and provide greater fiscal integrity to the fund.

Q: Why were there no funds available for a PBI for 2006 even though the ASRS fund has experienced returns greater than 8 percent in the last two years?

A: The pool of funds for the PBI has been fully paid out to retirees. Keep in mind that although the fund has earned more than 8 percent the past three fiscal years, earnings were below the 8 percent mark for the three previous years. The 10-year smoothing means years in which the fund earned less than 8 percent are still part of the formula to determine the availability of PBI funds each year throughout the 10-year rolling period. As years in which earnings were below 8 percent pass the 10-year mark, the outlook for future PBIs improves.

Q: When will another PBI be available?

A: Depending upon rates of return in future years, it could be several more years before the PBI pool is built back up to the point where a future PBI will be available.

Meet Your ASRS Investment Management Division Team

The ASRS is pleased to announce recent accomplishments of two members of the Investment Management Division (IMD).

Michael Viteri, Manager of Portfolio and Trading Strategies, was recently asked to become a member of the S&P U.S. Index Advisory Committee, a prestigious group of equity market participants that makes recommendations regarding the composition and management of various S&P indices. Also, Thomas Williams, Fixed Income Portfolio Manager, recently passed Level III of the Chartered Financial Analyst program.

A highly qualified IMD team, led by ASRS Director Paul Matson and Chief Investment Officer Gary Dokes, oversees the ASRS fund of more than \$24 billion, which ranks as the 100th largest pension fund, public or private, in the world. The Investment Management team directly manages six portfolios that total over \$7 billion, or approximately 30 percent of ASRS investment assets, and provides analysis and oversight of 27 external money managers.

"We have a team of professionals that I believe our members can be very proud of," Mr. Matson said. "With a fund the size of the ASRS, it's critical to maintain an environment that values communication, innovation, integrity and initiative. It's a real team effort that allows us to diligently manage ASRS investments with a clear investment philosophy."

The ASRS team places a high priority on experience, education and continuous learning. The investment division team includes:

Paul Matson, Director of the ASRS.

Mr. Matson has served as the director for the ASRS since his appointment to that position by the Board of Trustees in 2003. Prior to that, he served as Chief Investment Officer for the agency. Professional background: Master of Business

Administration (MBA); bachelor's degree in finance; Chartered Financial Analyst (CFA); Certified Investment Manager (CIM); Certified Cash Manager (CCM); Fellow of the Canadian Securities Institute (FCSI); past president of the Phoenix CFA Society; member of the Arizona Deferred Compensation Board; founding member Arizona-Canada Business Council.

MBA; bachelor's degree; member S&P U.S. Index Advisory Committee; Board member, City of Phoenix Deferred Compensation Plan; adjunct professor American Graduate School of International Management.

Eric Rovelli, Real Estate Portfolio Manager.

Mr. Rovelli has been with the ASRS since 2001 and manages the internally-traded Real Estate Investment Trust (REIT) portfolio and provides the strategic direction and implementation of the ASRS institutional real estate program. Professional background: bachelor's degree; Chartered Financial Analyst (CFA) charter holder; Certified Public Accountant.

Thomas Williams, Fixed Income Portfolio Manager.

Mr. Williams joined the ASRS in 2004 with prior experience in the private sector. Mr. Williams trades the internally-managed fixed

income portfolio and oversees ASRS cash management program. Professional background: bachelor's degree; recently passed Level III exam of the Chartered Financial Analyst (CFA) program and is currently awaiting award of the charter.

Lupita Breland, Fixed Income Portfolio Manager.

Ms. Breland has been with the ASRS since 1995 and currently provides the oversight of ASRS fixed income and international money managers. Professional background: MBA and bachelor's degree.

Ethan Hurley, Portfolio Analyst. Mr. Hurley has been with the ASRS since 2005 and is responsible for oversight of the ASRS real estate managers. Professional background: MBA and bachelor's degree.

Sarah Wadsworth, Portfolio Analyst. Ms. Wadsworth, the newest member of the team, is responsible for the oversight of the ASRS U.S. equity investment managers. Professional background: bachelor's degree.



The ASRS Investment Division team includes (from left to right) Michael Viteri, Thomas Williams, Eric Rovelli, Gary Dokes, Ethan Hurley, Sarah Wadsworth and Dan Kapanak. Not pictured is Lupita Breland.

Gary Dokes, Chief Investment Officer. Mr. Dokes has more than 20 years experience in institutional investment management and has been the CIO for the past three years. He is responsible for strategic and tactical asset allocation and for the day-to-day operational management of ASRS investments. Professional background: MBA; bachelor's degree in finance; Board member on the Arizona State College Savings Plan Oversight Committee.

Dan Kapanak, Manager of Investment Analysis. Mr. Kapanak has been with the ASRS since 2003, with prior work as a federal bank examiner with the FDIC. He specializes in quantitative investment analysis and financial risk management and oversees the activities of the ASRS portfolio analysts. Professional background: MBA and bachelor's degree.

Michael Viteri, Manager of Portfolio and Trading Strategies. Mr. Viteri has been with the ASRS since 1996 and oversees the management of ASRS internally-managed portfolios. Professional background:

Member Services

ASRS Offers Meetings to New Members, Retiring Members; New Format Coming in 2007

The Arizona State Retirement System conducts educational meetings available to all members. Whether newly hired and wanting to learn more about the retirement system and benefits, or nearing retirement and needing assistance in completing the proper paperwork and making annuity selections, the ASRS Member Services Division has a meeting for you.

Meetings are conducted throughout the year in the ASRS Phoenix and Tucson office, and throughout the state during spring and fall. To view a calendar of meeting dates and locations, please visit the ASRS website and click on



"Calendars" or call the Member Services Advisory Center at the numbers listed on page 8. You will find listings for Group Meetings, which are designed for members nearing retirement, and Seminars, meetings designed for newer members, and Service Purchase meetings, designed specifically for those wishing to buy service from previous qualified plans.

Coming in 2007 will be newly structured meetings!

"Getting Ready to Retire" will be the new name of the current Group Meeting. Getting Ready to Retire meetings will continue to be tailored to those who plan to retire within 12 months. Members will receive individualized benefit calculations and learn about potential monthly benefits and options, completing retirement paperwork, health insurance and return-to-work options.

"Know Your Benefits" will be the new name of the current Seminar meetings. This meeting will be open to all members and is especially helpful to new members. Information about the ASRS plan will be provided, along with a review of member responsibilities, wills and trusts, Social Security benefits and overall retirement income planning. A second portion of this meeting will be devoted to the ASRS Service Purchase Program, where members will learn about the process, types of service purchase, cost calculations and payment options.

For more information on member meetings, visit the ASRS website at www.azasrs.gov and click on Calendars at the top of the page.

System Member News

ASRS to Hold Meetings With Original System Members

The ASRS recently mailed a packet of information to a small group of members who are part of the original defined contribution "System," which has been closed to new members since the early 1970s.

The vast majority of the 440,000 ASRS members are part of the current Defined Benefit Plan, and are not affected by the following information.

System members are being informed about a series of meetings taking place in October to discuss possible options to the System that they may wish to consider.

These meetings that will take place throughout the state are designed to gather input from System members. The information packet that was mailed in early October included an outline of the issues, possible options, a meeting schedule and a feedback form.

System members are encouraged to review the packet, attend a meeting if possible, and provide their thoughts to the ASRS on the issues by early November.

Information is also available on the ASRS website, under the main category titled "System Members."

ASRS Publications Available On-line

Getting Ready for Retirement is your guide to planning your retirement! This 39-page guide covers how your retirement benefit is calculated, selecting your annuity option, filling out the necessary paperwork, information on health insurance and more!

ASRS Weekly Report is an electronic newsletter that is posted to the ASRS website. This report is updated weekly during the legislative session, and periodically when the legislature is not in session. The ASRS is currently exploring the format and distribution methods of the electronic newsletter and will provide updated information to members in the near future.

The *Comprehensive Annual Financial Report* for fiscal year that ended June 30, 2005 provides detailed information on Finances, Investments, Actuarial calculations and general Statistics of the ASRS. It includes the audited financial statements, which have been certified as a "fair and accurate" look at the fiscal stability of the retirement system.

These publications and others are available on the ASRS website at www.azasrs.gov.

Looking to the Future, *continued from page 1*

employees, a stated statutory purpose of the ASRS. It also allows the employer funds to be used to increase the funding of the Plan.

- For those not currently on Long Term Disability, changing the Social Security offsets (from 64% and 83% to 100%) and pre-existing condition provisions (from 3 months to 6 months) under the Long Term Disability program. These measures are intended to provide equitable benefits for members and bring the LTD program into better alignment with current industry standard practices.

No decisions have been made to move forward with any of these options. Before any decisions are made, the ASRS will engage in an outreach process this fall that will include seeking input from active employee groups, retiree groups and other stakeholders to discuss the pros and cons of these and other possible plan modifications. The Board of Trustees will also review and approve any proposed changes at public meetings before any potential approval is made. The effective date for any new proposal would approximately be January 2008.

The ASRS is in the process of researching these and other issues as part of its mission to provide the best plans for the most efficient costs to our members and retirees.

Director's Message, *continued from page 1*

In the first half of 2006, over 85 percent of service purchase cost invoices were issued within 15 business days, while less than 25 percent were issued this quickly just a year earlier. Furthermore, these service levels were achieved using fewer staff than had been required previously.

Surveys also provide valuable information on different ways we communicate with members. For example, our latest results show that members believe the website and this newsletter, *Financial Horizons*, have greatly improved. In the first half of 2006, 98 percent of members surveyed were satisfied with the website, and 98 percent were satisfied with *Financial Horizons*. Just a year earlier, satisfaction with these services was only 70 percent and 76 percent, respectively. Feedback on these surveys helps us to improve in all the ways we serve you, our members.

As our non-retired members have noticed, our annual member statement has also been re-designed in the past few years. Before finalizing the design of our statement, focus groups were conducted to learn members' reactions and suggestions for improvement. Overall, the new statement has been well received by members and also by peer retirement systems seeking to improve their own member statements. We have also conducted surveys with members to help us prioritize the design and rollout of future web services.

The next 24 months promises to be an exciting time, as the ASRS completes its business re-engineering and information technology plan efforts, including the automation of its disbursement services, development of new web applications, and the electronic imaging of its member files, which contain more than 10 million paper documents. These efforts will allow us to complete service transactions faster and more efficiently than ever before.

It is our goal to provide the best services possible for our members, retirees and employer partners.

Paul Matson, Director

ASRS Board of Trustees

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Public Representative

Karl Polen, Jr., Phoenix
Public Representative

Lawrence Trachtenberg, Scottsdale
Public Representative

Steven Zeman, Phoenix
Retirees Representative

Upcoming Board of Trustee Meetings

- October 20
- November 17
- December 15

Meetings are held in the 10th Floor Board Room of the ASRS offices at 3300 N. Central Avenue, Phoenix. Meetings begin at 8:30 a.m. and are open to the public. Meeting schedules, agendas and minutes are available on the ASRS website.

Executive Staff

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Chief Investment Officer

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Financial Horizons

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ASRS *Financial Horizons* is published by the Arizona State Retirement System. Information in the newsletter about retirement laws or policies is only a guide. If a conflict arises between information contained in the newsletter and the law, the law takes precedence.

ASRS Investments Exceed Target Rate of Return for Fiscal Year

The Arizona State Retirement System achieved a rate of return on its main portfolio of 9.8 percent and 11.4 percent on its LTD fund for the fiscal year that ended June 30. The total fund was just over \$24 billion.

The ASRS uses an assumed rate of return of 8 percent for purposes of its funding model to ensure adequate assets to pay current and future liabilities and benefits. The return of 9.8 percent puts the ASRS fund into positive investment performance for the third straight fiscal year and for 22 of the last 25 years.

The ASRS actual portfolio is a mix of U.S. stocks (about 56 percent); fixed income investments (25 percent); international equities (18 percent), and real estate investments (1 percent).

Investment Rates of Return

	1 Year (Fiscal Year '05-'06)	3 Year Average	5 Year Average	10 Year Average
ASRS Pension & Health Insurance Fund	9.8%	11.8%	5.6%	8.7%
ASRS U.S. Equity	10.0%	13.2%	3.9%	9.3%
ASRS U.S. Fixed Income	-0.4%	2.1%	5.0%	6.2%
ASRS International Equity	24.3%	22.8%	9.6%	8.3%
ASRS LTD Fund	11.4%	11.7%	n/a	9.4%